ST 01-0217-GIL 10/18/2001 COMPUTER SOFTWARE

The sale of canned or prewritten software is generally a taxable event, however, if real and substantial changes to the operation coding of canned or prewritten software is made to meet the specific individualized requirements of the purchaser for his limited or particular use, then the sales of such software may not be taxable. See 86 Ill. Adm. Code 130.1935 (This is a GIL).

October 18, 2001

Dear Xxxxx:

This is in response to your letter dated August 15, 2001. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found at http://www.revenue.state.il.us/legalinformation/regs/part1200.

In your letter you stated and made inquiry as follows:

We are in the processing of updating some sales/use tax taxability guidelines are in need of your opinion as to the taxability of the following items: (are items are separate stated per customer invoices)

(No TPP = No tangible personal property transferred with the service)

	Taxable	**Nontaxable**
Canned Software	_____	_____
Custom Software	_____	_____
Customized Software	_____	_____

What degree of 'modification' to a canned program will make the software 'custom?'

Modification Services	_____	_____
Consulting Services (No TPP)	_____	_____
Telephone Support (No TPP)	_____	_____
Software Maintenance (with TPP upgrades)	_____	_____
Software Maintenance (No TPP)	_____	_____
License Agreement Renewals	_____	_____
Freight/Delivery Charges for TPP	_____	_____
Website Development Services	_____	_____

We appreciate your assistance with this request. In addition to your answers to the above, please provide reference to applicable statutes and regulations.

As the general focus of your inquiry is in regards to computer software, I would like to direct your attention to the attached 86 Ill. Adm. Code Section 130.1935, which is the Department's regulation explaining the taxability of computer software. Provided below is a general discussion of the computer software and services taxation issues upon which you requested guidance.

Generally, the sale at retail, or transfer, of canned software intended for general or repeated use is taxable. Canned software is considered tangible personal property regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means or other media. See Section 130.1935(a).

A license of software, however, is not considered a taxable retail sale if the license meets all of the criteria set forth in Section 130.1935, including restricting the customer's use and duplication of the software, prohibiting the licensing or transferring of the software to a third party without permission, and requiring the customer to destroy or return all copies of the software to the licensor. Please refer to the subsection (a)(1)(A-E) of Section 130.1935 for a complete list and description of all the requirements for treatment as an exempt license. If a license agreement meeting all the requirements for treatment as an exempt license is renewed, the renewed license will also be treated as an exempt license if all the criteria set forth in Section 130.1935(a)(1)(A-E) continue to be met in the renewal agreement.

Custom software prepared to special order of the customer is not subject to tax under the Retailers' Occupation Tax, Use Tax, Service Occupation Tax, or Service Use Tax. Custom software does not include canned or prewritten computer software programs held for general or repeated sale or lease. See Section 130.1935(c). It must also be noted that to be considered custom software exempt from tax certain elements must present. Custom computer programs must be the result of (1) preparation and selection of the program for the customer's use, requiring an analysis of the customer's requirements by the vendor, and (2) adaptation of the program by the vendor to be used in a special environment, for example a particular make and model of a computer using a specific input or output device. See Section 130.1935(c)(1)(A-B).

Real and substantial changes must be made to pre-written or canned programs to constitute custom software. If the pre-written program was previously marketed, the new program will qualify as a custom program if the price of the pre-written program was 50% less of the price of the new program. If the pre-written program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced by the records of the seller, was more than 50% of the contract price to the consumer. See Section 130.1935(c)(3).

Modification of an existing prewritten program to meet a customer's specific need would be considered customize software and is considered exempt software, if, in addition to meeting the requirements of subsection (c)(1)(A-B), the software results from real and substantial changes to the operation coding of canned or prewritten software in order to meet specific individualized requirements of the purchaser for his limited or particular use. The services associated with modifying the canned or prewritten software into custom software are also not subject to tax if the result is custom software transferred to the customer. If, however, canned or prewritten software is modified but is also held for general or repeated sale or lease, then it is considered canned software and therefore taxable. See Section 130.1935(c)(2).

When tax is applicable, the tax applies to the entire charge made to the customer, including charges for all associated documentation and materials. Charges for training, telephone assistance, installation and consultation are exempt if they are separately stated from the selling price of canned software. See Section 130.1935(b).

Transportation and delivery charges, also designated as shipping and handling charges, are not taxable if the buyer and seller agree to such charges separately from the selling price of the tangible personal property and the charges are actually reflective of the costs of shipping. See the enclosed copy of 86 Ill. Adm. Code 130.415. To the extent the transportation and delivery charges exceed the costs of shipping, the charges will be subject to tax. The best evidence that transportation and delivery charges have been contracted for separate from the selling price, is a separate and distinct contract for transportation and delivery. However, documentation that demonstrates purchasers had the option of taking delivery of the property at the seller's location for the agreed purchase price, or having delivery made by the seller for the agreed purchase price plus an ascertained or ascertainable delivery charge will suffice.

When transportation and delivery charges are included in the selling price of the tangible personal property sold the charges are an element of the cost to the seller and are not deducted by the seller when computing Retailers' Occupation Tax liability. See 86 Ill. Adm. Code 130.415(c). Furthermore, transportation and delivery charges that are incurred by the seller in acquiring tangible personal property for sale are merely costs of doing business and are also not deductible when computing the seller's Retailers' Occupation Tax liability, regardless of the fact that the seller passes such costs on to the customer by quoting and billing such costs separately from the selling price of the property sold. See 130.415(e).

Maintenance agreements for software are treated in the same manner as all other maintenance agreements for other types of tangible personal property. Whether the sale of the maintenance agreement is a taxable event is dependent upon whether the charge for the maintenance agreement is included as part of the retail selling price of the tangible personal property covered by the maintenance agreement. If the charge for the maintenance agreement is included in the retail selling price, then the charge is part of the gross receipts of the retail transaction and is subject to tax under the Retailers' Occupation Tax. No further tax is incurred on the maintenance service or parts when the repair or service is completed.

If the maintenance agreement is not included in the selling price of the tangible personal property and instead is sold separately, the sale of the maintenance agreement is not taxable. However, when maintenance services or parts are subsequently provided under the maintenance agreement, the company providing the maintenance or repair will be acting as a service provider under the Service Occupation Tax Act. The Service Occupation Tax Act provides that when a service provider enters into an agreement to provide maintenance services for a particular piece of equipment for a stated period of time at a predetermined fee, the service provider incurs Use Tax based on its cost price of tangible personal property transferred to the customer incident to the completion of the maintenance agreement. Please see the enclosed copy of 86 Ill. Adm. Code 140.301(b)(3).

Maintenance agreements for software that include upgrades of canned software are considered to be sales of canned software and the whole agreement is taxable unless the upgrades are separately stated and taxed.

Website development services would be considered provision of a service. Retailers' Occupation Tax and Use Tax do not apply to receipts from sales of personal services. Instead, servicemen are taxed on the tangible personal property transferred incident to sales of service under the Service Occupation Tax Act. Please refer to the enclosed copy of 86 Ill. Adm. Code 140.101 regarding sales of service and the Service Occupation Tax. If tangible personal property is not transferred when providing a service, then the service provider incurs no tax liability.

The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the serviceman. The applicable tax depends upon which tax base the serviceman chooses to calculate his liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill; (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act.

I hope this information has been helpful. The Department of Revenue maintains a website, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales and use tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b).

Sincerely,

Dana Deen Kinion
Associate Counsel

DDK:msk
Enc.